Case study – Advising using Cash Flow Statements

This is the solution to the case study found at the end of:

- Chapter 10 *Cash Flow*

Dezzie's: cash flow statement for the year ending 31 March 20X4

	£	£
Operating profit		78 578
Add back: depreciation on buildings	2 000	
Depreciation on fixtures and fittings	1 829	
Depreciation on delivery vehicles	4 763	
Profit on sale of delivery vehicle	(520)	
		8 072
		86 650
Changes in working capital		
Stock (6 186 – 5 630) (cash outflow)	(556)	
Debtors (5 914 – 7 419) (cash inflow)	1 505	
Creditors (8 510 – 6 340) (cash inflow)	2 170	
Net change in working capital		3 119
Net cash inflow from operating activities		89 769
Interest		
Interest received (cash inflow)	280	

Interest paid (cash outflow)	(4 617)	
		(4 337)
Capital expenditure (103 000 + 2039 + 15 183) (cash outflow)	(120 222)	
Sale of delivery vehicle – sale proceeds	2 120	
		(118 102)
Proprietor's drawings (cash outflow)		(53 000)
Mortgage loan (cash inflow)		73 750
Net cash outflow		(11 920)
Change in cash balance:		
Cash at 1 April 20X3		15 160
Cash at 31 March 20X4		3 240
Decrease in cash – net cash outflow		(11 920)

Advice to Delroy Desmond

Delroy's business has suffered a net outflow of cash in the course of the year. The cash flow statement shows where the outflows have occurred. The principal items of outflow are, of course, the expenditure on new fixed assets. Delroy obtained a mortgage loan for some of the major expenditure on new premises, but financed part of it (£103 000 – 73 750 = £29 250) from the business's own resources. In addition, over £15 000 was spent on acquiring new delivery vehicles and a further £2000 on fixtures and fittings. The second largest item of cash outflow is Delroy's own drawings, which have increased substantially (£42 500 increasing to £53 000).

However, Delroy's business is profitable (net profit margin for the year ending 31 March 20X4 is 21.8%), and it has generated net cash inflows from operating activities of £89 769.

Delroy accepts the consultant's analysis of the operating problems the business faces. The accounting information suggests that Delroy is happy to make investments in bricks and mortar, but is quite prepared to skimp on the furnishing of his restaurants. We can see from the figures that the fixtures and fittings are quite old (this shows up in the relatively high figures for accumulated depreciation), and that only around £2000 was spent on new fixtures and fittings. Customers have obviously noticed Delroy's cheapskate approach to these matters, and are not happy about the appearance of the restaurants.

It appears that Delroy will be obliged to invest more money in restaurant fit out, new tables and so on, in order to keep the customers happy. He should be advised to do a thorough appraisal of the restaurant fittings and decoration, possibly in conjunction with an interior design expert (given that Delroy obviously has a blind spot in all matters relating to the appearance of his restaurants).

Over £15 000 has been spent on new delivery vehicles; this investment may address some of the problems noted by the customers of bikes breaking down and long waits for delivery. However, there could also be a problem with staffing, and it certainly appears to be the case that Delroy's managers are less effective than they should be. Delroy will have to arrange to employ higher paid staff. The obvious implication for cash and profits is that staffing expenses will increase. Also, he may have to spend extra cash on making existing staff redundant and could face legal problems if the staff consider themselves to have been unfairly dismissed.

However, if Delroy can sort out his staffing problems there are potential gains to be made in:

- Increased customer satisfaction (leading to word-of-mouth recommendations, and an increased rate of return visits)
- Better control of the delivery service, resulting in fewer complaints
- Improved quality of service within the restaurants

All of these factors could lead to increased turnover, and/or reduced costs.

Delroy's restaurants are profitable and bring in substantial sums of cash. The second restaurant has been open for only part of the year (we do not know from the details how long it has been open), and it could be expected to produce higher turnover and profits in the year ending 31 March 20X5. Delroy should prepare forecasts for at least the next following year, to show how much cash is likely to be available for spending on restaurant improvement and additional/replacement staffing.